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MONTHLY

VOLUME 10, ISSUE 2 FEBUARY 2013

ADAPTING TO NEW FEDERAL TAX RATES

Introduction

Before the presidential election last year, we published the November *Monthly* - "Tax Changes and Investment Returns". In that report, we outlined what we thought the likely changes to the federal tax code would be for 2013. As it turned out, our projections for the top marginal tax rates were accurate and after-tax returns for taxable investors in the highest tax brackets will unfortunately be higher going forward. In the November *Monthly*, we also discussed how the potential changes would impact the returns that taxable investors would realize in the years to come, and the implications for realizing capital gains before the new tax rates took effect.

In this *Monthly*, we review the tax changes and shift our focus to how the new rates impact both the returns and the risks that investors can expect from their portfolios in the future. We also examine how modifying a portfolio's asset mix can reduce the impact that higher tax rates have on long -term returns.

Our analysis focuses only on the effects of federal taxes on investors in the highest tax brackets, since these changes impact the majority of our clients and readers. Individuals should always take their own unique tax situations into account when making decisions about their taxable investments.

Federal Tax Changes

As of January 1st 2013, the 3.8% Medicare tax which was legislated as part of the Healthcare and Reconciliation Act of 2010 took effect. This tax applies to "unearned" investment income including capital gains and qualified dividends for individuals with modified adjusted gross income (MAGI) of over $200,000 and married couples with MAGI of over $250,000. The Medicare tax does not apply to interest paid on tax-exempt municipal bonds.

The broadest reaching changes in the federal tax code for 2013 were for taxes

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CURRENT TOPIC

Adapting to New Federal Tax Rates

Strategy

- *We made no strategy changes during the month of January.*
- *Portfolios remain overweight global equity exposure and underweight investment grade bond exposure.*

"AFTER-TAX RETURNS FOR TAXABLE INVESTORS IN THE HIGHEST TAX BRACKETS WILL UNFORTUNATELY BE HIGHER GOING FORWARD"

Figure 1 - 2013 Federal Tax Rate Changes (top brackets)

	2012 Tax Rates	2013 Tax Rates	Additional Medicare Tax	Total 2013 Taxes	Difference
Investment Income	35%	39.6%	3.8%	43.4%	+8.4%
Qualified Dividends	15%	20%	3.8%	23.8%	+8.8%
Long-Term Capital Gains	15%	20%	3.8%	23.8%	+8.8%
Municipal Bond Interest	0%	0%	0%	0%	0%

Sources: US Treasury Department, Stairway Partners

ADAPTIONG TO NEW FEDERAL TAX RATES - CONT'D

"THE RECENT INCREASE IN TAX RATES ACTUALLY REDUCES BOTH THE POSITIVE IMPACT OF GAINS AND THE NEGATIVE IMPACT OF LOSSES"

Figure 2 - Tax Rate Change Effect on Short-Term Expected Returns

	Before Tax Expected Returns	Prior Tax Rates: Tax Rates	Prior Tax Rates: After Tax Expected Return	Current Tax Rates: Tax Rates	Current Tax Rates: After Tax Expected Return	After-Tax Return Difference
US Equities						
Income	2.5%	15.0%	2.1%	23.8%	1.9%	-0.2%
+ Gain/(Loss)	5.9%	15.0%	5.0%	23.8%	4.5%	-0.5%
Total	8.4%		7.1%		6.4%	-0.7%
US Aggregate Bonds						
Income	3.0%	35.0%	2.0%	43.4%	1.7%	-0.3%
+ Gain/(Loss)	-4.4%	15.0%	-3.7%	23.8%	-3.3%	+0.4%
Total	-1.4%		-1.8%		-1.6%	+0.2%

on ordinary income, which includes the interest paid on taxable bonds and non-qualified corporate dividends. For ordinary income, a new bracket with a 39.6% tax rate was added above what was previously the highest bracket with a 35% tax rate. The new bracket applies to annual income over $400,000 for individuals and $450,000 for married couples.

Dividends paid by US companies and registered foreign companies continue to qualify for favorable tax treatment, if an investor holds the equity of the company for a specified period of time. Otherwise, dividends are taxed as ordinary income, which has a higher rate. The tax rate applied to qualified dividends for individuals in the highest bracket increased from 15% to 20% as of the beginning of this year.

Figure 1 outlines all of the federal tax changes discussed above and shows the overall effect on the various components of investment returns.

Higher Taxes and Investment Risk

It is obvious that higher taxes on income and capital gains reduce the expected returns that taxable investors in the highest tax brackets should expect from their portfolios. What is less obvious is that higher taxes can also reduce the risk that is realized by taxable investors. This is because the government's claim on a portion of realized returns effectively makes them an investment partner, sharing in both gains and losses. The result of the government's involvement is that the volatility of an investor's after-tax return is reduced as the magnitude of their retained gains and losses is reduced by taxation.

Investors may not feel like this is the case, since they usually see changes in their investments' value through monthly statements which do not reflect the effects of taxation. Measuring after-tax performance on a portfolio is difficult for investors, since taxes are often paid from a different account based on a much broader range of activity including wages and other investments. This makes the construction of tax-efficient portfolios all the more important, since monitoring results is difficult.

Figure 2 illustrates how the recent increases in tax rates actually reduces both the positive impact of anticipated gains and the negative impact of anticipated losses, by dissecting the expected after-tax returns that we report on the last page of this publication.

The negative effect of increased taxes on income and capital gains needs little explanation. Higher tax rates mean that more of an investment's pre-tax return accrues to the government, leaving a lower after-tax return for the investor. The figure shows that this is the case for US equities, where our forward looking valuation model anticipates positive income and capital gains.

The results for bonds are not as intuitively obvious. In the current market environment, after-tax returns for bonds are actually expected to increase with higher taxes, as a larger portion of the anticipated capital loss can be used to offset gains in other investments.

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Source: Stairway Partners

About Stairway Partners, LLC

Stairway Partners was formed to provide our clients (starting with ourselves) with an effective and comprehensive solution for managing their wealth. Our disciplined and rigorous approach comes from our collective knowledge in serving large institutional clients over many years.

Our core investment belief is that asset allocation is the single most important determinant of success in any investment plan. The dominant amount of risk and return comes not from your choice of individual investments but from your asset class mix. Stairway Partners focuses our resources on risk management and asset allocation. This includes building your custom blueprint (investment policy and benchmark) and aligning your portfolio with our investment strategy utilizing the global capital markets.

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Long-Term Asset Allocation

Figure 3 shows the after-tax return and risk characteristics of the major asset classes that we follow, based on the current tax rates. With the exception of tax-exempt municipal bonds, the recent changes to the tax code reduced the expected after-tax returns for these asset classes by between 10% and 15%. The after-tax risks on all of the asset classes including municipal bonds decreased. This is because capital gains and losses on municipal bonds are not exempt from taxation. As a result, municipal bonds become more attractive for taxable investors relative to the other asset classes. The relative attractiveness between the other asset classes are not materially impacted by the recent tax changes.

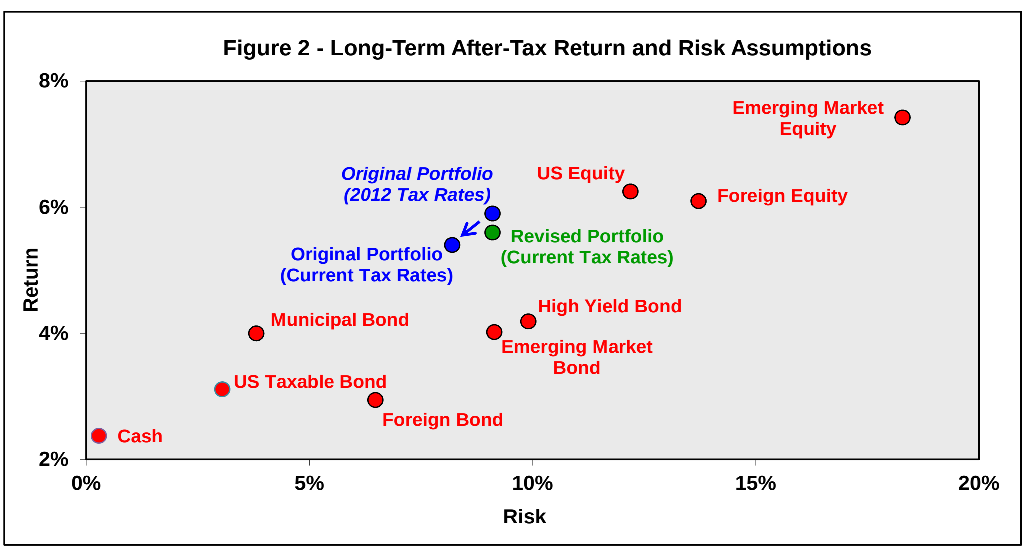
When constructing a balanced portfolio, investors generally choose a mix of assets which they believe will provide attractive returns and not subject them to more risk than they are comfortable with. Since the recent tax increases lowered the portion of risk that a taxable investor experiences, it is possible that a balanced portfolio which was set up before the changes may now be too conservative.

An example of this is illustrated in figure 3, where a balanced portfolio is shown to migrate lower on both the return and risk spectrums due to the higher tax rates enacted at the beginning of this year. The figure also shows that revising the original balanced portfolio's asset allocation to bring the risk level back in line with the risk level that was chosen when the portfolio was originally created can help to offset some of the reduction in long-term returns associated with the increased tax rates.

Conclusion

The recent federal tax increases will lower after-tax returns for many taxable investors going forward. However, on an after-tax basis, these changes will also reduce the impact of market gyrations on their portfolios.

By taking both the risk and the return implications of the recent tax changes into account, investors with balanced portfolios might benefit by modifying their asset mix to maintain their prior level of risk and potentially improve their long-term returns.



Source: Stairway Partners

> "SINCE THE RECENT TAX INCREASES LOWERED THE PORTION OF RISK THAT A TAXABLE INVESTOR EXPERIENCES, IT IS POSSIBLE THAT A BALANCED PORTFOLIO WHICH WAS SET UP BEFORE THE CHANGES MAY NOW BE TOO CONSERVATIVE"

3 Year Annualized Return Estimates for Global Markets

2/1/2013	Total Returns			After-Tax Total Returns		
	Expected	Hurdle	Excess	Expected	Hurdle	Excess
Equities						
United States	**8.4%**	**4.0%**	**4.4%**	**6.4%**	**3.8%**	**2.6%**
Non-US Developed Markets	**15.7%**	**4.5%**	**11.2%**	**11.9%**	**4.3%**	**7.6%**
EMU	22.2%	4.9%	17.4%	17.0%	4.7%	12.2%
UK	22.4%	4.8%	17.6%	17.0%	4.7%	12.3%
Japan	7.1%	4.9%	2.1%	5.4%	4.8%	0.6%
Canada	-2.3%	4.3%	-6.6%	-1.7%	4.1%	-5.9%
Emerging Markets	**18.8%**	**5.8%**	**13.1%**	**14.0%**	**5.6%**	**8.4%**
Fixed Income						
US Aggregate	**-1.4%**	**2.0%**	**-3.5%**	**-1.6%**	**1.9%**	**-3.4%**
US Treasuries						
2 Year	-0.1%	0.8%	-0.9%	-0.3%	0.6%	-1.0%
5 Year	-2.1%	1.3%	-3.4%	-2.0%	1.1%	-3.1%
10 Year	-4.6%	1.8%	-6.4%	-3.9%	1.7%	-5.6%
30 Year	-7.2%	2.0%	-9.2%	-5.9%	1.8%	-7.7%
TIPS						
5 Year	-2.4%	1.4%	-3.8%	-2.2%	1.2%	-3.4%
10 Year	-6.0%	1.9%	-8.0%	-5.0%	1.8%	-6.7%
30 Year	-13.9%	2.3%	-16.2%	-10.5%	2.1%	-12.6%
Municipal	**-0.6%**	**1.4%**	**-2.0%**	**0.2%**	**1.2%**	**-1.0%**
2 Year	0.1%	0.7%	-0.6%	0.4%	0.5%	-0.1%
5 Year	-1.3%	1.1%	-2.4%	-0.5%	0.9%	-1.4%
10 Year	-1.9%	1.5%	-3.4%	-0.7%	1.3%	-2.0%
20 Year	-0.2%	1.8%	-1.9%	0.8%	1.6%	-0.8%
High Yield	**0.6%**	**2.9%**	**-2.4%**	**-0.7%**	**2.8%**	**-3.5%**
High Quality High Yield	0.8%	2.1%	-1.3%	-0.4%	2.0%	-2.4%
Emerging Market ($ demonimnated)	**-1.8%**	**3.2%**	**-5.0%**	**-2.2%**	**3.0%**	**-5.2%**
Foreign Aggregate	**-2.7%**	**3.4%**	**-6.1%**	**-2.4%**	**3.3%**	**-5.7%**
Foreign Aggregate (hedged)	-3.1%	1.7%	-4.8%	-2.6%	1.6%	-4.2%
Foreign Treasury	**-2.2%**	**3.0%**	**-5.2%**	**-2.0%**	**2.8%**	**-4.8%**
Foreign Treasury (hedged)	-3.3%	1.3%	-4.6%	-2.6%	1.1%	-3.8%
Cash	**0.5%**	**0.5%**	**0.0%**	**0.3%**	**0.3%**	**0.0%**
Foreign Currency (versus US$)						
Euro	-3.1%	2.3%	-5.4%			
British Pound	-0.1%	2.2%	-2.3%			
Japanese Yen	4.8%	2.4%	2.3%			
Canadian Dollar	-0.3%	1.4%	-1.7%			

Notes
1. Foreign market returns assume US dollar as the base currency and are unhedged unless otherwise indicated.
2. All hurdle returns are based on long-term asset volatility. Equity and fixed income hurdle rates include expected cash returns.
3. After-tax total returns assume that all gains and losses are long-term and realized within the investment horizon.
4. After-tax total returns only take into account Federal taxes based on the following tax rates:
   - 43.4% Ordinary Income, 23.8% Qualified Income, 0% Exempt Income, and 23.8% Capital Gains/(Losses)